B5350-3A

The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Chief Economist

NOVEMBER 1986

Economic Forecast For 1987

Once again, congratulations are in order. Confounding the pessimists who had written it off as early as two years ago, the current economic expansion has achieved another milestone—its fourth birthday. As a result, the upswing has moved into third place in terms of postwar longevity. And that includes the 106-month expansion which encompassed the Vietnam War; compared with peacetime expansions only, the current upswing is now the second longest and rapidly closing in on the longest, the 58-month expansion which took place in the last half of the 1970s.

It has been a most interesting recovery, to say the least. This is because it is strong in some dimensions and weak in others. Perhaps this "split personality" is what has led some analysts to predict a recession when none has occurred, while others projected a boom with similar disappointing results. For example, looking at the output statistics alone, it would appear that this expansion has been weaker than average. As against a 21 percent gain in the gross national product adjusted for inflation for all recoveries which lasted this long, the current upswing has registered little more than a 16 percent rise in real GNP. However, it is not because of a lack of spending. Real domestic demand has risen by 22.2 percent during the current expansion, compared with 21.9 percent, on average, for the others. The difference stems largely from foreign trade. Real exports have grown only 11 percent in the past four years, less than half the 24.3 percent rise that has taken place in past 48-month upswings. By contrast, real imports have shot up by nearly 66 percent—almost twice the 33.8 percent average rise.

The sluggishness in the output side of the economy has helped drive inflation lower. We have made much more progress in reducing the rate of inflation this time around than we had on average in the past—or, for that matter, in any single postwar expansion. Indeed, the usual case is for the rate of inflation to accelerate when the economy grows. The fact that inflation was reduced at a time when the money supply has grown much faster than it ever has makes this development even more remarkable. Rather than fueling inflation, the surge in money growth appears to have helped push up stock prices. The Dow Jones Industrial Average has jumped by 76½ percent over the past four years—more than three times its average rise and 1½ times greater than the next largest increase which occurred during the 1954-57 expansion.

Despite Cloudy Crystal Balls ...

What, then, do all these comparisons mean for the year ahead? Will this expansion live to celebrate its fifth birthday, thus becoming the longest peacetime expansion in the postwar era? The answer, up front, would appear to be in the affirmative—notwithstanding the existence of more than the usual number of uncertainties clouding a forecaster's crystal ball. To begin with, the fact that the ongoing expansion has lasted four years is, just by itself, an uncertainty, since it is already 14 months longer than the average peacetime expansion. While there is no law which limits the life of an expansion, the fact that we have had so many recessions—not just in the postwar era, but stretching back into the early part of the 19th century—would seem to suggest, that sooner or later, this expansion will come to a halt, too.

The trade deficit is another uncertainty. Driving a wedge between consumption and production, the trade deficit may have peaked, but it is unclear how rapidly it will diminish, since the dollar is not as weak as is generally supposed (Economic Report—September 1986). And if the trade deficit remains large and the goods-producing sector stays weak, there may well come a point when this weakness will spill over and begin to affect those sectors that remain strong, notably services, construction and consumer spending.

The next issue will appear in January.

Copyright 1986
Manufacturers Hanover
270 Park Avenue, New York, N.Y. 10017

Besides these economic uncertainties, there are two political uncertainties which cloud the outlook. The first is tax reform—which represents a major restructuring of the nation's tax system. It has already produced significant cuts in business spending owing to the removal of the investment tax credit and changes in depreciation allowances. It is no doubt affecting consumer spending right now, since sales tax deductions will be eliminated for items purchased after December 31, 1986. And until people are certain as to whether they will come out ahead or behind, they are likely to spend cautiously, producing a further drag on economic activity.

The second political uncertainty is the Gramm-Rudman Deficit Reduction Act. As you know, this mandates a sizable cut in Washington's budget deficit year by year until balance is achieved in 1991. The problem is that the target for fiscal year 1986 which ended September 30 was overshot by a wide margin, as Washington's budget deficit came in at $220 billion. In view of this, it does not seem likely that the target for the current fiscal year, a deficit of $144 billion with a $10 billion leeway, will be met.

The uncertainty deals with just exactly how much the deficit will be brought down and whether or not it will be in line with the expectations of financial market participants. For you see, when this act was passed last year, it helped spark a sizable rally in the financial markets because it appeared at that time that the Government had finally found the key to achieving a balanced budget. However, the decision by the Supreme Court earlier this year which knocked out the automatic spending cut provision, opened the door to 1986's overshoot. If the Administration and Congress cut the deficit too much, it could pull the economy down into a recession. On the other hand, if they don't cut the deficit enough, it could cause a significant backup in interest rates, which would also bode ill for the business outlook.

... The Absence of Imbalances ...

Having said all this, our forecast for 1987, as you can see from the table, calls for continued growth with no recession in sight. The year as a whole may log in about the same average growth rate as 1986 and 1985, but the quarterly pattern should be up after softness early in the year. We base this moderately optimistic outlook on the absence of pre-recession signals along with the presence of pro-growth signs.

Developments which have tended to occur immediately prior to a recession are nowhere in sight:

- The economy is *not* overheating. There is enough idle capacity, unemployed workers, and supplies of commodities to keep the economy's temperature, in the form of the rate of inflation, moderate;
- The Federal Reserve is *not* tightening. Interest rates have declined over the past year, with short-term rates well below long-term yields, while the supply of money and credit is growing rapidly. If anything, the Fed may ease another notch before long;
- Fiscal policy is *not* restrictive. Washington's budget deficit, as noted above, continues to grow;
- Consumer demand is *not* contracting. In the first nine months of this year real personal consumption outlays climbed by a healthy 5.6 percent—with a 7.2 percent leap in third-quarter 1986. Continued growth is expected, albeit at a slower pace, since attitudes are positive, buying power is still growing, savings are adequate and use of debt is not as high as it seems;
- The stock market is *not* falling. Equities, as measured by the Dow Jones Industrial Average, have been trading in a relatively narrow range for the past half year, thus keeping both business and consumer confidence at high levels. The record shows that recessions don't usually begin while the market is performing this way;

Besides the absence of negatives, consider the existence of several positive developments:

- *Lower oil prices,* which, although causing severe cutbacks in spending by companies engaged in the business of exploring for, refining and selling of oil, have also boosted the buying power of both business and consumers by lowering many costs;
- *Lower interest rates,* which may have reduced the interest income of those who save, but have also cut costs of those who borrow;
- *The lower dollar,* which, although not down everywhere, has fallen sufficiently against the currencies of enough countries to stop the growth in our trade deficit, thus curbing the drain on output it represents;
- *The jump in employment,* which has produced record numbers of people with jobs, has added to buying power—not to mention bolstered confidence;
- *Higher stock and bond prices,* which have enhanced the purchasing power of those owning these instruments, as well as the attitudes of others.

November, 1986
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual			Projected >								
	1986				YEAR 1986		1987				YEAR 1987	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	4149.2	4175.6	4234.3	4283.1	4210.6	5.3	4324.6	4380.1	4451.0	4526.0	4420.4	5.0
GNP: $82	3655.9	3661.4	3683.3	3717.5	3679.5	2.6	3731.3	3758.1	3793.6	3830.6	3778.4	2.7
% Change, Annual Rates	3.8	0.6	2.4	3.8	2.6		1.5	2.9	3.8	4.0	2.7	
Consumption	2697.9	2732.0	2799.3	2806.2	2758.9	6.1	2845.9	2885.2	2930.9	2977.9	2910.0	5.5
Durables	360.8	373.9	410.2	389.5	383.6	6.8	392.8	397.4	404.8	411.0	401.5	4.7
Non-Durables	929.7	928.4	935.5	944.3	934.5	3.2	956.3	967.5	979.9	993.4	974.3	4.3
Services	1407.4	1429.8	1453.6	1472.4	1440.8	7.8	1496.9	1520.3	1546.2	1573.5	1534.2	6.5
Investment	708.3	687.3	674.7	698.1	692.1	4.7	694.2	698.0	712.2	720.8	706.3	2.1
Non-Residential	459.2	457.5	461.1	466.0	460.9	0.6	451.7	458.9	461.4	475.1	461.7	0.2
Producers Durable Equipment	304.6	316.0	321.5	329.0	317.8	4.7	317.6	323.6	324.4	335.4	325.3	2.3
Structures	154.6	141.5	139.6	136.9	143.1	-7.5	134.0	135.3	136.9	139.7	136.5	-4.7
Residential	205.3	215.3	221.1	219.8	215.4	12.3	221.6	224.0	226.8	231.0	225.9	4.9
Inventory Changes	43.8	14.5	-7.5	12.3	15.8		20.9	15.2	24.0	14.7	18.7	
Net Exports	-93.7	-104.5	-110.1	-108.0	-104.1		-96.6	-89.4	-86.2	-81.8	-88.5	
Government Purchases	836.7	860.8	870.4	886.9	863.7	5.9	881.1	886.3	894.1	909.1	892.7	3.4
Federal Defense	266.4	278.4	277.0	278.7	275.1	6.1	281.5	282.1	283.0	283.5	282.5	2.7
Federal Civilian	89.3	89.2	88.8	104.7	93.0	-1.9	94.1	92.0	91.1	98.2	93.8	0.9
State & Local	480.9	493.3	504.7	503.5	495.6	7.4	505.5	512.3	520.1	527.3	516.3	4.2
Final Sales: $82	3616.1	3646.3	3687.8	3706.7	3664.2	2.5	3712.3	3743.7	3771.2	3817.0	3761.0	2.6
% Change, Annual Rates	-1.3	3.4	4.6	2.1	2.5		0.6	3.4	3.0	4.9	2.6	
Domestic Demand: $82	3781.8	3815.3	3847.9	3856.0	3825.3	3.6	3845.9	3861.9	3889.0	3915.1	3878.0	1.4
% Change, Annual Rates	3.0	3.6	3.5	0.8	3.6		-1.0	1.7	2.8	2.7	1.4	
Final Domestic Demand: $82	3741.9	3800.2	3852.4	3845.2	3809.9	3.4	3827.0	3847.5	3866.5	3901.5	3860.6	1.3
% Change, Annual Rates	-1.9	6.4	5.6	-0.7	3.4		-1.9	2.2	2.0	3.7	1.3	
GNP Price Index (1982 = 100)	113.5	114.0	115.0	115.2	114.4	2.6	115.9	116.6	117.3	118.2	117.0	2.2
% Change, Annual Rates	2.3	2.0	3.3	0.9	2.6		2.4	2.3	2.7	2.8	2.2	
Consumer Price Index (1967 = 100)	327.7	326.3	328.4	331.3	328.4	2.0	334.3	337.1	340.5	344.1	339.0	3.2
% Change, Annual Rates	1.4	-1.7	2.6	3.6	2.0		3.7	3.3	4.1	4.4	3.2	
Total Personal Income	3432.6	3483.3	3501.6	3543.3	3490.2	5.3	3582.9	3627.8	3678.8	3742.0	3657.9	4.8
Disposable Personal Income	2935.1	2978.5	2983.0	3015.0	2977.9	5.3	3076.2	3112.5	3153.8	3204.4	3136.7	5.3
Savings Rate	5.0	5.1	2.9	3.7	4.2		4.2	4.1	3.8	3.8	4.0	
Unemployment Rate	7.1	7.2	6.9	6.9	7.0		6.9	6.8	6.8	6.7	6.8	
Indus. Production (1977 = 100)	125.0	124.4	125.1	126.3	125.2	1.1	125.3	126.6	128.6	130.2	127.7	2.0
Housing Starts (000)	1998.3	1908.0	1760.0	1792.0	1864.6	7.1	1748.7	1744.1	1757.4	1777.5	1756.9	-5.8
Domestic Auto Sales (000)	7837.0	8144.7	9699.7	7085.9	8191.8	-0.2	7284.8	7737.4	7776.7	7970.9	7692.4	-6.1
Corporate Pre-Tax Profits	224.3	231.3	243.7	265.3	241.1	8.1	261.9	273.1	293.4	301.2	282.4	17.1
-Taxes	107.1	111.2	115.3	123.3	114.2		123.3	129.9	139.6	143.1	134.0	
Net Profits	117.2	120.1	128.4	142.5	127.1	-3.3	139.1	143.7	154.4	158.6	148.9	17.2
-Dividend Payments	85.2	87.5	88.8	89.8	87.8	7.6	91.0	92.0	93.0	94.0	92.5	5.3
Undistributed Profits	32.0	32.6	39.6	52.7	39.2	-21.2	48.1	51.7	61.3	64.5	56.4	43.8
+Depreciation	330.9	330.2	331.8	334.8	331.9		335.8	336.6	337.3	338.1	336.9	
-Inventory Profits	-16.5	-10.6	-7.1	9.2	-6.3		8.6	9.7	14.8	15.3	12.1	
Net Cash Flow	379.4	373.4	378.5	378.3	377.4	0.5	375.2	378.6	383.9	387.3	381.2	1.0

Along with continued growth in the economy will come a pickup in the rate of inflation. However, considering the fact that prices at the consumer level declined during the second quarter of this year, while at the producer or wholesale level they remain below year-ago levels, one should not be overly concerned that this represents the first step on the road toward overheating. For whatever increase we do experience in the rate of inflation will have little to do with the pace of expansion, since, as noted above, there is plenty of slack in the economy in the form of idle workers, excess capacity and surplus commodities.

The expected pickup in the rate of inflation can be traced to other developments. For one thing, prices of imported merchandise are rising. This alone, adds to domestic inflation. However, when imported goods' prices rise, they are usually followed by price increases posted by domestic manufacturers who now have more leeway than before, when imports' prices were steady. Another factor that will produce more inflation is oil prices. Admittedly, the price of oil is well below year-ago levels in spot markets. However, it is undeniably higher than earlier this year and if the oil-producing countries can adhere to their production agreement, the price of oil will firm even further. Reduced efficiencies that stem from the combination of high levels of employment and shortages of workers with certain skills and the cutbacks in capital spending, will also add to inflation. Finally, the fact that over half of the consumer price index—the services portion—is already rising at more than a five percent annual rate should be taken into account as well.

... Assures Continued Expansion

In conclusion, the best bet is that the economic expansion will continue and that a year from now the birthday cake will have one more candle on it. The current and projected state of the economy may not seem to be ideal for many—but it is far from negative for most. Maybe this is why the expansion will live on.

NO POSTAGE
NECESSARY
IF MAILED
IN THE
UNITED STATES

BUSINESS REPLY MAIL
FIRST CLASS PERMIT NO. 3455 NEW YORK, N.Y.

Postage Will Be Paid By Addressee

MANUFACTURERS HANOVER TRUST COMPANY
ECONOMICS DEPARTMENT
270 PARK AVENUE
NEW YORK, NEW YORK 10017

A

Do you wish to continue receiving our **ECONOMIC REPORT?**

If you wish to continue receiving the Economic Report, please return this entire back page by December 19, 1986. If you wish to change the way we are addressing you, simply mark the change on the label, below.

When returning this entire back page, please refold so the top panel (marked A) becomes the mailing side—and the bottom panel (marked C) with your label is folded in. Staple or tape the top of the refolded page.

Thank you,
ECONOMICS DEPARTMENT

IF YOU DO NOT RETURN THIS PAGE BY DECEMBER 19, WE WILL REMOVE YOUR NAME FROM OUR MAILING LIST.

B

TO PEOPLE OUTSIDE THE U.S. WHO WISH TO REMAIN ON OUR MAILING LIST – please return this entire page in your personal or company envelope.

The Manufacturers Hanover
Economic Report
Bank Window, Church St. Station
New York, New York 10015

First Class Mail
U.S. Postage
PAID
New York, N.Y.
Permit No. 5766

IMPORTANT
Want to remain on our mailing list to receive Economic Report? See above!

C

20P 20P006990 C 928 CONGR0001
SRI ACQUISITIONS
CONGRESSIONAL INFORMATION
SERVICE, INC.
4520 EAST-WEST HWY., SUITE 800
WASHINGTON, DC 20014